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No. 90-416

IN THE

Supreme Court of the United States

OCTOBER TERM, 1990

ROCCO DiLEO and LOUISE DiLEO,

Petitioners,

vs.

ERNST & YOUNG,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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QUESTIONS PRESENTED

1. Does an allegation that defendant had actual knowledge of the materially false and misleading nature of its statements and omissions or acted with reckless disregard for the truth fulfill the provision of Rule 9(b) of the Federal Rules of Civil Procedure that malice, intent, knowledge, and other condition of mind of a person may be "averred generally" or must a complaint also plead facts from which the requisite state of mind may be "inferred"?

2. In an action by outside shareholders of a publicly traded company, are allegations (i) identifying false financial statements certified by defendant upon which plaintiffs' claim is based, (ii) setting forth misstatements of specific assets, liabilities, reserves and income, (iii) quantifying the misstatements by alleging that outstanding loans were overstated by $4 billion, and that interest income was overstated by $600 million, and (iv) citing accounting standards violated by defendant sufficient to state the "circumstances" constituting fraud with the "particularity" required by the first sentence of Rule 9(b), or must detailed "examples", i.e., evidence concerning specific customer accounts of the issuer which were misstated, be alleged?

LIST OF PARTIES

Petitioners-plaintiffs are Rocco DiLeo and Louise DiLeo who bring this action as purchasers of shares of Continental Illinois Corporation, the holding company of Continental Illinois National Bank. The Court of Appeals did not determine whether the action could be maintained on behalf of other purchasers as a class. (App. p. 10)

Respondent-defendant is the accounting firm of Ernst & Young, successor to Ernst & Whinney.

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Petitioner prays that a Writ of Certiorari issue to review the judgment of the United States Court of Appeals for the Seventh Circuit entered in this cause on May 7, 1990.

REPORTS OF OPINIONS

The opinion of the United States Court of Appeals for the Seventh Circuit from which petitioners seek review is reported at 901 F.2d 624 (7th Cir. 1990), and is reproduced in the Appendix at pp. 1-10. The opinion of the district court is not reported and is reproduced in the Appendix at pp. 13-16.

JURISDICTION

The judgment sought to be reviewed was entered on May 7, 1990. Petition for rehearing was denied on June 12, 1990. The Court has jurisdiction to review the judgment by writ of certiorari pursuant to 28 U.S.C. §1254(1).

RULE INVOLVED

Fed.R.Civ.P. 9(b).

Fraud, Mistake, Condition of the Mind. In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally.

STATEMENT OF THE CASE

Plaintiffs, purchasers of shares of Continental Illinois Corporation, brought this action against the accounting firm which certified Continental's financial statements for the years 1982 and 1983. Plaintiffs alleged that the value of the shares purchased was artificially inflated, in part, by the fraudulent certification of those financial statements by defendant. Plaintiffs' action was brought pursuant to §10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and S.E.C. Rule 10b-5, 17 C.F.R., §240.10b-5. The district court's jurisdiction was based upon §27 of the Securities Exchange Act of 1934, 15 U.S.C. 78aa.

Plaintiffs appealed from an order dismissing their complaint. The complaint alleges that Continental's financial statements for the years 1982 and 1983, certified by defendant, were false; that defendant entered into a scheme with Continental and its officers and directors to conceal Continental's true financial condition; that in Continental's 1982 financial statements provision for credit losses was stated at $492 million, which was an understatement of $600 million; that reported net credit losses of $393.2 million were understated by $4 billion in bad loans; that Continental's loan portfolio was overstated by $4 billion; and that Continental's net interest income after provision for credit losses was overstated by $600 million. The complaint also identifies and quantifies misstatements of a similar nature in Continental's 1983 financial statements. The relevant portions of the complaint are reproduced in the Appendix at pp. 19-48.

Defendant certified that Continental's financial statements presented fairly its financial position, the results of its operations and changes in its financial position, all in conformity with generally accepted accounting principles applied on a consistent basis. The complaint alleges that these certifications were false, and cites financial accounting standards, regulations and industry guides violated by defendant in certifying Continental's financial statements.[1]

Plaintiffs' complaint further alleges that defendant had actual knowledge of the materially false and misleading nature of the financial statements and omissions therein,

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[1] Although the decision sought to be reviewed contains extended discussion relating to the issue of secondary liability under the securities laws, plaintiffs' complaint alleges that defendant is primarily liable for certifying fraudulent financial statements.

or acted with reckless disregard for the truth in failing to ascertain and disclose material facts.

The district court dismissed plaintiffs' complaint pursuant to a Rule 12(b)(6) motion to dismiss for failure to comply with the pleading requirements of Rule 9(b). The United States Court of Appeals for the Seventh Circuit affirmed on the grounds that: (1) the complaint did not "afford a basis for believing that plaintiffs could prove scienter" and that the complaint must "support an inference of scienter" (App. pp. 9 and 10), and (2) the complaint failed to comply with the requirement of Rule 9(b) that circumstances constituting fraud shall be stated with particularity because it did not give "examples of problem loans." (App. p. 4)

REASONS FOR GRANTING THE WRIT

THIS COURT SHOULD RESOLVE TWO DISTINCT CONFLICTS AMONG THE COURTS OF APPEALS CONCERNING THE PLEADING REQUIREMENTS UNDER RULE 9(b) OF THE FEDERAL RULES OF CIVIL PROCEDURE: (1) WHETHER STATE OF MIND MAY BE AVERRED GENERALLY, OR RATHER, MUST CIRCUMSTANCES FROM WHICH STATE OF MIND IS TO BE "INFERRED" BE PLEADED; AND (2) WHETHER PLEADING THE SPECIFIC TIME, PLACE AND NATURE OF FRAUDULENT CONDUCT STATES "CIRCUMSTANCES" WITH REQUISITE "PARTICULARITY", OR RATHER, MUST "EXAMPLES", I.E., EVIDENCE, BE ALLEGED.

A.

Rule 9(b) of the Federal Rules of Civil Procedure provides:

> In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally.

Rule 9(b) has not been amended since it took effect in 1938 and, although there has been a substantial amount of litigation under the rule,[2] this Court has never had occasion to determine how it should be applied.[3] The pleading standards set forth in Rule 9(b) have wide applicability to the practice and procedure in the courts of the United States, and this Court should resolve existing conflicts among courts of appeals concerning construction and application of the rule.

B.

To state a claim under §10(b) of the Securities Exchange Act of 1934, plaintiffs must allege scienter, i.e., "intent to deceive, manipulate or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 201 (1976). Thus, scienter as a form of "malice, intent, knowledge, and other condition of mind" falls within the ambit of the second sentence of Rule 9(b) and "may be averred generally." This is confirmed by the Notes of Advisory Committee on Rules, which direct one to *English Rules Under the Judicature*

[2] Shepard's Federal Rules Citations, 1987, shows 15½ columns of citations to Rule 9(b). The June 1990 Supplement adds an additional 12 columns of citations.

[3] In *Klapprott v. United States*, 335 U.S. 601, 603, *modified*, 336 U.S. 942 (1949) the court stated: "For the requirement that allegations of fraud be particularized, see Rule 9(b) of the Rules of Civil Procedure." That passing reference is the only citation by this Court of the rule.

Act, published in The Annual Practice, 1937. That publication states at 0.19, r.22, at p.369:

> Wherever it is material to allege malice, fraudulent intention, knowledge, or other condition of the mind of any person, it shall be sufficient to allege the same as a fact without setting out the circumstances from which the same is to be inferred.

Consistent with this reasoning, the Third and Fourth Circuits permit scienter in the securities fraud context to be pleaded generally. Thus, in *Christides v. First Pennsylvania Mortgage Trust*, 717 F.2d 96, 99 (3d Cir. 1983), as to whether scienter could be alleged generally, the court stated:

> The second sentence [of Rule 9(b)] requires only that "intent, knowledge, and other condition of mind . . . be averred generally."

See also Seattle-First National Bank v. Carlstedt, 800 F.2d 1008, 1011 (10th Cir. 1986), and *Cramer v. General Telephone & Electronics Corp.*, 582 F.2d 259, 273 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979).

In the action before the Court, plaintiffs pleaded that defendant "either had actual knowledge of the materially false and misleading nature [of the financial statements it certified] or acted with reckless disregard for the truth in failing to ascertain and disclose the material facts."[4]

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[4] This court twice has reserved for decision the issue of whether recklessness is sufficient to comply with the scienter requisite of an action brought pursuant to §10(b) of the Securities Exchange Act. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 (1976), and *Herman & MacLean v. Huddleston*, 459 U.S. 375, 378 (1983). With the decision in *Backman v. Polaroid Corp.*, 893 F.2d 1405 (1st Cir. 1990) *rev'd on rehearing on other grounds*, Fed.Sec.L.Rep. (CCH) ¶95,389 (August 2, 1990), at least ten circuits have determined that an allegation of recklessness adequately pleads scienter under §10(b).

The Seventh Circuit upheld dismissal of plaintiff's complaint under Rule 12(b)(6) ruling that the complaint did not "afford a basis for believing that plaintiffs could *prove* scienter" and did not "support an *inference* of scienter." (App. pp. 9 and 10, emphasis added.)

The Seventh Circuit has now joined the Second Circuit in requiring the pleading of facts providing an *inference* of a person's condition of mind. As stated in 2A, Moore's Federal Practice, ¶9.03[3], p. 9-51:

> Since Rule 9(b) by its terms allows intent and knowledge to be averred generally, most courts do not require the pleader to allege scienter particularly. However, in the Second Circuit, plaintiffs must plead facts giving rise to a strong inference of knowledge or reckless conduct by the defendants.

See, e.g., Devaney v. Chester, 813 F.2d 566, 568 (2d Cir. 1987).

The position of the Seventh and Second Circuits that a complaint based on securities fraud must provide a basis for *inferring* that the defendant had the requisite mental state, in addition to being contrary to the "plain language" of Rule 9(b)[5] and the source cited in the Notes of Advisory Committee on Rules, conflicts with other Circuits' construction of the second sentence of Rule 9(b).

The Court should grant a writ of certiorari to resolve the conflict among the Circuits and to provide a uniform

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[5] In *Herman & MacLean v. Huddleston*, 459 U.S. 375, 390-91 (1983) at n. 30 the Court stated: "If anything, the difficulty of proving the defendant's state of mind supports a lower standard of proof." Just as mental state is not normally susceptible to direct proof, so it is not practically feasible to require a person to plead facts from which it can be inferred. The drafters of Rule 9(b) so realized and therefore provided that condition of mind "may be averred generally."

standard for pleading state of mind in the courts of the United States.

C.

The first sentence of Rule 9(b) provides: "In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity." Plaintiffs' complaint alleges that Continental's financial statements for the years 1982 and 1983, certified by defendant, were false; that they overstated the asset value of Continental's loan portfolio by at least $4 billion; that net interest income after provision for credit losses was overstated by at least $600 million; and cites financial accounting standards, regulations and industry guides violated by defendant in certifying the financial statements. Those allegations do allege the "circumstances" of the claim against defendant with "particularity."

In the opinion from which review is sought, the Seventh Circuit abandoned its prior construction of the particularity standard of Rule 9(b),[6] found plaintiffs' complaint to lack adequate particularity, and required the pleading of evidence. The decision states:

> The complaint does not, however, give *examples* of problem loans that E & W should have caught, or explain how it did or should have recognized that the provisions for reserves established by Continental's loan officers were inaccurate. (App. p. 4, emphasis added.)

After quoting portions of the complaint specifying and quantifying misstatements in the financial statements, the

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[6] *Tomera v. Galt*, 511 F.2d 504 (7th Cir. 1975).

Court of Appeals states, "the complaint has more in the same vein, but not a single *concrete example.*" (Emphasis added.) The decision by the Court of Appeals goes beyond requiring that the "circumstances" of fraud "be stated with particularity", and demands the pleading of evidentiary details.[7]

The newly adopted pleading standard demanded by the Seventh Circuit is uniquely and particularly onerous. The only Court of Appeals whose interpretation of Rule 9(b) is roughly comparable is that for the Second Circuit. *Denny v. Barber*, 576 F.2d 465 (2d Cir. 1978).

The Courts of Appeals for other Circuits construe the particularity standard for pleading "circumstances" of fraud to require only identification of the time, place and nature of the fraudulent conduct. *See, e.g., Wool v. Tandem Computers, Inc.*, 818 F.2d 1433, 1439 (9th Cir. 1987):

> But "pleading is sufficient under Rule 9(b) if it identifies 'the circumstances constituting fraud so that the defendant can prepare an adequate answer from the allegations' ". . . While mere conclusory allegations of fraud are insufficient, statements of the time, place and nature of the alleged fraudulent activities are sufficient. [Citations omitted.]

Accord Seattle-First National Bank v. Carlstedt, 800 F.2d 1008 (10th Cir. 1986), and *Durham v. Business Management Associates*, 847 F.2d 1505 (11th Cir. 1988).

[7] Many of the authorities cited by the Seventh Circuit in affirming dismissal of the complaint relate to the question of evidentiary proof and not to the issue of whether a pleading states a claim upon which relief can be granted. The court's citation of *Matsushita Electric Industrial Co. v. Zenith Radio Corp.*, 475 U.S. 574, 587 (1986) perverts this Court's holding in that case, and applies a standard relating to granting a motion for summary judgment to a motion to dismiss a pleading under Rule 12(b)(6).

The Court should resolve the conflict among the Courts of Appeals concerning construction of the particularity standard under Rule 9(b).

D.

In addition to evidencing two different conflicts among Courts of Appeals concerning interpretation of Rule 9(b), the Seventh Circuit's construction of the Rule frustrates Congress' intent in enacting the securities laws to protect purchasers of publicly traded securities.[8] In most cases, the evidentiary detail required by the decision would be available only to an insider, and generally would be unavailable to outsiders who purchase through public markets. Under the pleading standards adopted by the Seventh Circuit, persons who purchase shares publicly would rarely have access to the facts necessary to state a claim under §10(b) of the Securities and Exchange Act of 1934.

CONCLUSION

The Seventh Circuit's construction of Rule 9(b) is wholly contrary to the basic pleading concepts of the Federal Rules of Civil Procedure. As stated by the Court in *Conley v. Gibson*, 355 U.S. 41, 48 (1957):

> Following the simple guide of Rule 8(f) that "all pleadings shall be so construed as to do substantial justice," we have no doubt that petitioners' complaint

[8] *See Landreth Timber Co. v. Landreth*, 471 U.S. 681, 687 (1985) and *Gould v. Ruefenacht*, 471 U.S. 701, 706 (1985).

adequately set forth a claim and gave the respondents fair notice of its basis. The Federal Rules reject the approach that pleading is a game of skill in which one misstep by counsel may be decisive to the outcome and accept the principle that the purpose of pleading is to facilitate a proper decision on the merits.

Two distinct conflicts among the courts of appeals, each applying to construction of one of the two sentences of Rule 9(b), should be resolved; the Court should provide guidance to the courts of the United States concerning pleading requirements under the Federal Rules of Civil Procedure; the Court should confirm reasonable pleading standards which do not create artificial procedural barriers to substantive rights created by laws enacted by Congress; the Petition for Writ of Certiorari should be granted.

Respectfully submitted,

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September 10, 1990

APPENDIX

IN THE
UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

Nos. 89-2027 and 89-2183

ROCCO DILEO and LOUISE DILEO,

Plaintiffs-Appellants,

v.

ERNST & YOUNG,

Defendant-Appellee.

Appeals from the United States District Court
for the Northern District of Illinois, Eastern Division.
No. 84 C 7305—**George M. Marovich,** *Judge.*

ARGUED FEBRUARY 27, 1990—DECIDED MAY 7, 1990

Before FLAUM, EASTERBROOK, and RIPPLE, *Circuit Judges.*

EASTERBROOK, *Circuit Judge.* Continental Illinois Bank's financial distress during the 1980s left many victims, from taxpayers (who injected some $2 billion to keep the bank afloat) to equity investors (who lost most of the value of their stock) to some of its officers (now spending time in prison) to bonding companies and insurers (which must compensate the firm for injuries caused by employees' delicts). Litigation was bound to erupt. Cases that have reached us include *FDIC v. Hartford Insurance Co.*, 877 F.2d 590 (7th Cir. 1989); *In re National Union Fire Insurance Co.*, 839 F.2d 1226 (7th Cir. 1988); *United States*

v. Patterson, 827 F.2d 184 (7th Cir. 1987); *FDIC v. O'Neil*, 809 F.2d 350 (7th Cir. 1987); *In re Continental Illinois Securities Litigation*, 732 F.2d 1302 (7th Cir. 1984).

Purchasers of Continental's securities filed suit against Continental, its officers and other employees, and those who helped it sell instruments, including lawyers, investment bankers, and accountants. Some of these suits have produced substantial judgments or settlements. Rocco and Louise DiLeo filed this case under §10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b), and the SEC's Rule 10b-5, 17 C.F.R. §240.10b-5, as a class action against Ernst & Whinney (now Ernst & Young), Continental's accountant for the 1982 and 1983 fiscal years. The district court declined to certify the class, stating that it duplicated another suit that had been settled. It then dismissed the DiLeos' suit. The appeal concerns only securities fraud; other theories in the complaint have been dropped.

The rationale behind the judgment is obscure. This is the district judge's complete explanation:

> Judge Zagel found that plaintiffs in their original complaint alleged no facts to show E&W's recklessness or knowledge of falsity or intent to deceive. The first amended complaint does not correct this omission. The court finds that the plaintiffs have failed to plead scienter, have not pled facts to establish the elements of aiding and abetting by E&W, and have not pled with the specificity required by F.R.C.P. 9(b). Count I is dismissed with prejudice for the reasons set forth in E&W's briefs.

The parties did not favor us with Judge Zagel's opinion, and in any event the complaint grew after the initial dismissal. The additions could be important, and the court should have analyzed them. Circuit Rule 50, which requires a judge to give reasons for dismissing a complaint, serves three functions: to create the mental discipline that an obligation to state reasons produces, to assure the parties that the court has considered the important arguments, and to enable a reviewing court to know the reasons for

the judgment. A reference to another judge's opinion at an earlier stage of the case, plus an unreasoned statement of legal conclusions, fulfils none of these.

The judge accepted the "reasons set forth in E&W's briefs" in the district court. Even if we had copies of these briefs (no one supplied them to us), they would be inadequate. A district judge could not photocopy a lawyer's brief and issue it as an opinion. Briefs are argumentative, partisan submissions. Judges should evaluate briefs and produce a neutral conclusion, not repeat an advocate's oratory. From time to time district judges extract portions of briefs and use them as the basis of opinions. We have disapproved this practice because it disguises the judge's reasons and portrays the court as an advocate's tool, even when the judge adds some words of his own. E.g., *Walton v. United Consumers Club, Inc.*, 786 F.2d 303, 313-14 (7th Cir. 1986); *In re X-Cel, Inc.*, 776 F.2d 130 (7th Cir. 1985). Judicial adoption of an entire brief is worse. It withholds information about what arguments, in particular, the court found persuasive, and why it rejected contrary views. Unvarnished incorporation of a brief is a practice we hope to see no more.

Failure to state reasons for a decision ordinarily would lead to a remand. Yet the DiLeos do not request this step. Because the district court granted a motion under Fed. R. Civ. P. 9(b) and 12(b)(6), our review is plenary. A remand would prolong the case without contributing to accurate resolution. Because the complaint is fatally inadequate, we affirm the judgment in order to spare both the parties and the court gratuitous travail.

Plaintiffs advance two theories: that E&W violated the securities laws directly by certifying fraudulent financial statements that were incorporated into documents such as Continental's annual Form 10-K, and that E&W aided and abetted Continental's violations of the securities laws. Let us start with the first of these. Continental got into trouble when risky loans did not pay off. During the early 1980s Continental identified ever-larger volumes of nonper-

forming loans and established reserves. Almost every financial report announced a higher reserve than its predecessor. The gist of the DiLeos' complaint is that Continental did not increase its reserves fast enough. The central allegation of the complaint, ¶42(a), is that before the class members bought their stock E&W "became aware that a substantial amount of the receivables reported in Continental's financial statements were likely to be uncollectible." The complaint does not, however, give examples of problem loans that E&W should have caught, or explain how it did or should have recognized that the provisions for reserves established by Continental's loan officers were inaccurate. Paragraph 46(c) is the closest the complaint approaches to specificity:

> (i) At Annual Report page 22, provisions for credit losses were stated at $492 million, which failed to reflect the material amounts of credits for which reserves should have been taken, in additional amounts of at least $600 million.
>
> (ii) At page 22, net credit losses of $393.2 million were materially understated by approximately $4 billion in bad loans.
>
> (iii) At page 22, non-performing loans were reported at approximately $1.9 billion which materially understated the amount of loans which were not performing or which had been restructured to give the illusion that they were currently meeting obligations. . . .

The complaint has more in the same vein, but not a single concrete example.

Four billion dollars is a big number, but even a large column of big numbers need not add up to fraud. For any bad loan the time comes when the debtor's failure is so plain that the loan is written down or written off. No matter when a bank does this, someone may say that it should have acted sooner. If all that is involved is a dispute about the timing of the writeoff, based on estimates of the probability that a particular debtor will pay, we do not have

fraud; we may not even have negligence. Recklessness or fraud in making loans is not the same as fraud in discovering and revealing that the portfolio has turned sour.

Securities laws do not guarantee sound business practices and do not protect investors against reverses. *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977); *Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509 (7th Cir. 1989). When a firm loses money in its business operations, investors feel the loss keenly. Shifting these losses from one group of investors to another does not diminish their amplitude, any more than rearranging the deck chairs on the Titanic prevents its sinking. Revealing the bad loans earlier might have helped the DiLeos, but it would have injured other investors by an equal amount. The net is a wash. Awards on account of business failure, even the expenses of litigation on the subject, *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 740 (1975), would discourage firms from taking risk in the first place. This would make investors as a whole worse off. Securities laws designed to protect investors' interests should not be read to increase the costs of ordinary business and so disserve their own ends. *Flamm v. Eberstadt*, 814 F.2d 1169, 1176-78 (7th Cir. 1987).

Investors seeking relief under Rule 10b-5 have to distinguish their situation from that of many others who are adversely affected by business reverses. *Wielgos; Christidis v. First Pennsylvania Mortgage Trust*, 717 F.2d 96, 99-100 (3d Cir. 1983). This complaint fails to do so. You cannot tell from reading it why the DiLeos believe that the problems were so apparent that reserves should have been jacked up before the end of 1983—why failure to increase the reserves amounted to "fraud". Fed. R. Civ. P. 9(b) requires the plaintiff to state "with particularity" any "circumstances constituting fraud". Although states of mind may be pleaded generally, the "circumstances" must be pleaded in detail. This means the who, what, when, where, and how: the first paragraph of any newspaper story. None of this appears in the complaint, although the flood of information released about Continen-

tal Bank since 1984 offers ample fodder if there is indeed a tale to tell.

The story in this complaint is familiar in securities litigation. At one time the firm bathes itself in a favorable light. Later the firm discloses that things are less rosy. The plaintiff contends that the difference must be attributable to fraud. "Must be" is the critical phrase, for the complaint offers no information other than the differences between the two statements of the firm's condition. Because only a fraction of financial deteriorations reflects fraud, plaintiffs may not proffer the different financial statements and rest. Investors must point to some facts suggesting that the difference is attributable to fraud. *Goldberg v. Household Bank, f.s.b.*, 890 F.2d 965 (7th Cir. 1989); *First Interstate Bank v. Chapman & Cutler*, 837 F.2d 775, 780 (7th Cir. 1988); *Denny v. Barber*, 576 F.2d 465 (2d Cir. 1978) (Friendly, J.). That ingredient is missing in the DiLeos' complaint. It presents nothing other than the change in the stated condition of the firm to suggest that E&W was so much as negligent in auditing Continental's financial statements. Rule 9(b) required the district court to dismiss the complaint, which discloses none of the circumstances that might separate fraud from the benefit of hindsight. There is no "fraud by hindsight", in Judge Friendly's felicitous phrase, *Denny*, 576 F.2d at 470, and hindsight is all the DiLeos offer.

We arrive at the DiLeos' second theory: that E&W aided and abetted Continental Bank's violation of the securities laws. The complaint gives more reason to suppose that some of Continental's employees committed securities fraud than that E&W did. As the DiLeos paint things, E&W assisted in the employees' scheme by lending its name to the financial statements and keeping its mouth shut about what was really going on. Such a theory might support liability even if none of the statements E&W made or certified was fraudulent.

As an original matter there is substantial doubt whether §10(b) and Rule 10b-5 impose liability on those who do

not themselves commit fraud but only assist others who do so. Daniel R. Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 Calif. L. Rev. 80 (1981). Twice the Supreme Court has reserved the question. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 191 n.7 (1976); *Herman & Maclean v. Huddleston*, 459 U.S. 375, 379 n.5 (1983). Our court is the home of the leading case supporting liability for aiders and abettors, *Brennan v. Midwestern United Life Insurance Co.*, 259 F. Supp. 673 (N.D. Ind. 1966) (Eschbach, J.), affirmed, 417 F.2d 147 (7th Cir. 1969), and we stand by this conclusion until a higher court, not bound by our 20+ years' precedent, resolves it. E.g., *Congregation of the Passion v. Kidder Peabody & Co.*, 800 F.2d 177, 183 (7th Cir. 1986); *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 495 (7th Cir. 1986).

An accountant's liability for aiding and abetting is hard to distinguish from primary liability. After all, the securities laws forbid material omissions that render misleading what has been stated. When an accountant certifies that a firm's financial statements "present fairly" its financial position (the standard language of the profession), it is certifying the absence of materially misleading omissions, a source of primary liability. If it acts with the necessary mental state, the case for direct liability is complete. Liability for aiding and abetting as a *distinctive* theory then is something of an invitation to impose damages on an accountant even though the omissions were not material, or the accountant lacked scienter, or some other element of a violation was missing. We have accordingly been careful not to treat aiding and abetting as an open-ended invitation to create liability without fault. *Barker* holds, 797 F.2d at 495-97, and more recent cases reiterate, that there can be no liability on an aiding-and-abetting theory unless (1) someone committed a primary violation, (2) positive law obliges the abettor to disclose the truth, and (3) the abettor fails to do this, with the same degree of scienter necessary for the primary violation. E.g., *LHLC Corp. v. Cluett, Peabody & Co.*, 842 F.2d 928, 932 (7th Cir. 1988); *Chapman & Cutler*, 837 F.2d at 780 & nn. 4, 5;

Congregation of the Passion, 800 F.2d at 183-84. See also *Schlifke v. Seafirst Corp.*, 866 F.2d 935 (7th Cir. 1989). There may be additional requirements, *Barker*, 797 F.2d at 496, but we need not attempt a catalog.

Whether or not the complaint suffices to allege that someone at Continental Bank committed securities fraud, it utterly fails to allege duty and scienter on the part of E&W. The securities laws do not impose general duties to speak, *Basic, Inc. v. Levinson*, 485 U.S. 224, 239 & n.17 (1988); therefore, as *Barker* held, these must usually be located in state law, if they exist at all. E&W performed its audit in Illinois, so its law is the right one to consult. The DiLeos do not argue to us that Illinois requires accountants to blow the whistle on improper behavior by their clients. Although accountants must exercise care in giving opinions on the accuracy and adequacy of firms' financial statements, they owe no broader duty to search and sing. *Latigo Ventures v. Laventhol & Horwath*, 876 F.2d 1322, 1327 (7th Cir. 1989). Such a duty would prevent the client from reposing in the accountant the trust that is essential to an accurate audit. Firms would withhold documents, allow auditors to see but not copy, and otherwise emulate the CIA, if they feared that access might lead to destructive disclosure—for even an honest firm may fear that one of its accountant's many auditors would misunderstand the situation and ring the tocsin needlessly, with great loss to the firm. Duties to disclose or pay damages would raise the costs of all audits, as accountants increased fees to cover anticipated liabilities. Honest enterprises would pay these fees no less than dishonest (for until the audit ended, an accountant could not tell which was which). So firms would purchase less accounting service, and investors in all firms would lose at both ends: the price would go up as the amount of oversight went down.

Moreover, the complaint offers no reason to infer that E&W possessed the mental state necessary for a primary violation. Although Rule 9(b) does not require "particularity" with respect to the defendants' mental state, the com-

plaint still must afford a basis for believing that plaintiffs could prove scienter. *Barker* observed, 797 F.2d at 497, that the case "against an aider, abettor, or conspirator may not rest on a bare inference that the defendant 'must have had' knowledge of the facts. The plaintiff must support the inference with some reason to conclude that the defendant has thrown in his lot with the primary violators." See also *Schlifke*, 866 F.2d at 948. The complaint does not allege that E&W had anything to gain from any fraud by Continental Bank. An accountant's greatest asset is its reputation for honesty, followed closely by its reputation for careful work. Fees for two years' audits could not approach the losses E&W would suffer from a perception that it would muffle a client's fraud. And although the interests of E&W's partners and associates who worked on the Continental audits may have diverged from the firm's, see *AMPAT/Midwest, Inc. v. Illinois Tool Works, Inc.*, 896 F.2d 1035, 1043 (7th Cir. 1990), covering up fraud and imposing large damages on the partnership will bring a halt to the most promising career. E&W's partners shared none of the gain from any fraud and were exposed to a large fraction of the loss. It would have been irrational for any of them to have joined cause with Continental.

People sometimes act irrationally, but indulging ready inferences of irrationality would too easily allow the inference that ordinary business reverses are fraud. One who believes that another has behaved irrationally has to make a strong case. *Matsushita Electric Industrial Co. v. Zenith Radio Corp.*, 475 U.S. 574, 587 (1986); *Mid-State Fertilizer Co. v. Exchange National Bank*, 877 F.2d 1333, 1339 (7th Cir. 1989); *Goldberg*, 890 F.2d at 967. The complaint does not come close. It does not identify any of E&W's auditors or explain why that person might have had to gain from covering up Continental's wrongs. It offers only rote conclusions, such as ¶61:

> E&W herein either had actual knowledge of the materially false and misleading nature of the statements and omissions set forth above, or acted with reckless

> disregard for the truth in failing to ascertain and disclose the material facts or aided and abetted the unlawful conduct alleged herein.

Boilerplate of this kind does not suffice. To accept it would undo the principles established in *Barker* and subsequent cases. What the DiLeos needed to show, if not that E&W had something to gain from deceit, was at least that E&W knew that particular loans had gone bad and could not be collected; an allegation that E&W joined with Continental in preparing the financial statements does not support an inference of scienter without knowledge of this kind, which, as we have observed above, the complaint does not allege.

Because the DiLeos lose on the merits, we need not decide whether the district court properly dismissed the class aspects of their claim. If the dismissal was erroneous, the other members of the class would be brought into this case and join the DiLeos in defeat. If the dismissal was correct, the other members of the class will be unable to file a new suit (the statute of limitations has run), so again they cannot recover. One way or the other, the remaining investors are out of luck, so it is unnecessary to decide just which way.

AFFIRMED

A true Copy:

Teste:

Clerk of the United States Court of Appeals for the Seventh Circuit

UNITED STATES COURT OF APPEALS
For the Seventh Circuit
Chicago, Illinois 60604

JUDGMENT – WITH ORAL ARGUMENT

May 7, 1990

Before

Honorable Joel M. Flaum, Circuit Judge
Honorable Frank H. Easterbrook, Circuit Judge
Honorable Kenneth F. Ripple, Circuit Judge

Nos. 89-2027 and 89-2183

ROCCO DILEO and LOUISE DILEO,

Plaintiffs-Appellants

v.

ERNST & YOUNG,

Defendant-Appellee

Appeal from the United States District Court for the
Northern District of Illinois, Eastern Division.
Nos. 84 C 7305, 85 C 9872, 86 C 9475—**George M. Marovich,** *Judge.*

These causes were heard on the record from the above mentioned district court, and was argued by counsel.

On consideration whereof, IT IS ORDERED AND ADJUDGED by this Court that the judgment of the District Court in these causes appealed from be, and the same is hereby, AFFIRMED with costs, in accordance with the opinion of this Court filed this date.

UNITED STATES COURT OF APPEALS
For the Seventh Circuit
Chicago, Illinois 60604

June 12, 1990.

Before

Hon. JOEL M. FLAUM, Circuit Judge
Hon. FRANK H. EASTERBROOK, Circuit Judge
Hon. KENNETH F. RIPPLE, Circuit Judge

Nos. 89-2027 and 89-2183

ROCCO DILEO and LOUISE DILEO,

Plaintiffs-Appellants,

v.

ERNST & YOUNG,

Defendant-Appellee.

Appeals from the United States District Court for the Northern District of Illinois, Eastern Division.
No. 84 C 7305—**George M. Marovich,** *Judge.*

ORDER

Plaintiffs-Appellants filed a petition for rehearing and suggestion of rehearing en banc on May 21, 1990. No judge in regular active service has requested a vote on the suggestion of rehearing en banc, and all of the judges on the panel have voted to deny rehearing. The petition for rehearing is therefore DENIED.

[Dated April 17, 1989]

IN THE
UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

ROCCO DI LEO, et al.,

Plaintiffs,

v.

RAYMOND C. BAUMHART, S.J., et al.,

Defendants.

No. 84 C 7305—JUDGE MAROVICH

MEMORANDUM OPINION AND ORDER

This matter is before the court on defendant Ernst and Whinney's ("E&W") motion to dismiss plaintiff's first amended complaint. The claims asserted against other defendants have been voluntarily dismissed and E&W remains as the only defendant.

The issues before the court are: (1) whether this action is duplicative of previous litigation; (2) whether under F.R.C.P. 9(b) Count I is pled with requisite particularity; (3) whether under F.R.C.P. 12(b)(6) plaintiff's RICO claim (Count III) was adequately pled; (4) whether a fraud claim is stated with respect to Count V. The court makes the following rulings:

1. *Plaintiff's Class Action is Duplicative*

E&W contends that the complaint is duplicative of the class action in *Spring v. Continental Illinois Corporation, et al.*, 84 C 4648, and thus the court should dismiss the

action under F.R.C.P. 23(b)(3) and 24. The court agrees for the reasons set forth in E&W's briefs.

The Di Leos opted out of the *Spring* class and the plaintiffs cannot now bring another class action suit based on the same factual scenario. Their class action must be dismissed with prejudice as duplicative of *Spring*. While the DiLeos have all their rights as individuals to sue E&W, they cannot sue as the representatives of the shareholder class.

2. *Plaintiffs Fail to Plead Securities Fraud*

Judge Zagel found that plaintiffs in their original complaint alleged no facts to show E&W's recklessness or knowledge of falsity or intent to deceive. The first amended complaint does not correct this omission. The court finds that the plaintiffs have failed to plead scienter, have not pled facts to establish the elements of aiding and abetting by E&W, and have not pled with the specificity required by F.R.C.P. 9(b). Count I is dismissed with prejudice for the reasons set forth in E&W's briefs.

3. *Plaintiffs Do Not Plead A RICO Claim*

Judge Zagel found that Count III of the original complaint, the RICO count, was deficient in a number of respects. He found fault with both the "enterprise" allegations and the "pattern" allegations. The first amended complaint is likewise deficient, particularly in regard to the allegations of a RICO pattern.

In *Jones v. Lampe*, 845 F.2d 755 (7th Cir. 1988) the court set forth the pattern requirements established in this circuit. The Seventh Circuit requires either multiple schemes or multiple injuries occurring as a result of one

scheme. Multiple acts in furtherance of one scheme, without more, does not make a RICO pattern. Here, the DiLeos allege one scheme culminating in one infliction of injury.

Accordingly, Count III is dismissed with prejudice.

4. *Count V Does Not Allege Common Law Fraud By E&W*

Because the allegedly fraudulent misrepresentations were made in Illinois, to state a cause of action for common law fraud plaintiffs must plead and prove that: (1) E&W made a false representation of material facts with knowledge of the falsity at the time the statements were made and with the expectation that the plaintiffs would rely on the statements; (2) the plaintiffs justifiably relied on the statements and sustained damages as a consequence. *Shofstall v. Allied Van Lines, Inc.*, 455 F. Supp. 351 (N.D. Ill. 1978). Like a fraud-based section 10(b) violation, common law fraud must be stated with particularity. F.R.C.P. 9(b). *Schmidt v. Landfeld*, 20 Ill. 2d 89, 169 N.E. 2d 229 (1960). Here, plaintiffs' allegations are nonspecific as to particulars.

Most significantly, plaintiffs do not allege that they relied on E&W's misrepresentations. A plaintiff's actual reliance upon the misrepresentations is still a necessary element in an Illinois fraud action. *Trautman v. Knights of Columbus*, 121 Ill. App. 3d 911, 460 N.E. 2d 350 (1984). Plaintiffs have not stated facts which comprise all the necessary elements of common law fraud and Count V is accordingly dismissed with prejudice for failure to state a claim.

Conclusion

For all of the foregoing reasons, plaintiffs' first amended complaint against E&W is dismissed with prejudice.

ENTER:

/s/ GEORGE M. MAROVICH
United States District Judge

DATED: April 17, 1989

[Dated April 17, 1989]

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

Case Number: 84 C 7305 Date: April 17, 1989

Name of Assigned Judge: GEORGE M. MAROVICH

Case Title: Rocco Di Leo, et al
vs Raymond C. Baumhart, S.J., et al

* * * * *

DOCKET ENTRY:

(1) ☒ Judgment is entered as follows:

(2) ☐ [Other docket entry:]

Enter Memorandum Opinion and Order. For the reasons stated in the memorandum opinion and order, plaintiffs' first amended complaint against E&W is dismissed with prejudice.

* * * * *

(12) ☒ [For further detail see ☐ order on the reverse of ☒ order attached to the original minute order form.]

* * * * *

[Dated April 17, 1989]

UNITED STATES DISTRICT COURT
Northern District of Illinois
Eastern Division

JUDGMENT IN A CIVIL CASE

CASE NUMBER: 84 C 7305

Rocco DiLeo, et al

v.

Raymond C. Baumhart, S.J., et al

☐ Jury Verdict. This action came before the Court for a trial by jury. The issues have been tried and the jury has rendered its verdict.

☒ Decision by Court. This action came to trial or hearing before the Court. The issues have been tried or heard and a decision has been rendered.

IT IS ORDERED AND ADJUDGED that for the reasons stated in the court's memorandum opinion and order, plaintiffs' first amended complaint against E&W is dismissed with prejudice.

Date APR 17, 1989

H. STUART CUNNINGHAM
Clerk

/s/ McClendon Grice
McClendon Grice
(By) Deputy Clerk

[DATED JUNE 9, 1988]

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 84 C 7305
TRIAL BY JURY DEMANDED

ROCCO DiLEO and LOUISE DiLEO,

Plaintiffs,

v.

RAYMOND C. BAUMHART, S.J., JAMES F. BERE, WESTON R. CHRISTOPHERSON, ROBERT A. HANSON, WILLIAM B. JOHNSON, JEWEL S. LAFONTANT, VERNON R. LOUCKS, JR., FRANK W. LUERSSEN, ROBERT H. MALOTT, MARVIN G. MITCHELL, KEITH R. POTTER, JOHN M. RICHMAN, PAUL J. RIZZO, THOMAS H. ROBERTS, JR., WILLIAM L. WEISS, BLAINE J. YARRINGTON, ROGER E. ANDERSON, JOHN H. PERKINS, DONALD C. MILLER, EDWARD S. BOTTOM, DAVID G. TAYLOR, GEORGE R. BAKER, GAIL M. MELICK, CONTINENTAL ILLINOIS CORPORATION; CONTINENTAL ILLINOIS NATIONAL BANK & TRUST COMPANY OF CHICAGO and ERNST & WHINNEY,

Defendants.

FIRST AMENDED COMPLAINT

Now come the plaintiffs, Rocco DiLeo and Louise DiLeo, husband and wife, on behalf of themselves and all those similarly situated, by their attorneys, and for their complaint against the defendants state as follows:

ALLEGATIONS COMMON TO ALL COUNTS

Plaintiffs

1. (a) Plaintiffs Rocco DiLeo and Louise DiLeo, husband and wife, reside within the United States District Court for the Northern District of Illinois.

(b) Plaintiffs made the following purchases of Continental Illinois Corporation (the "Corporation") common stock:

June 24, 1983	1,000 shares at $22-1/8
May 17, 1984	500 shares at $10-1/4

Plaintiff Class

2. Plaintiffs bring this action individually and on behalf of all those persons (other than the defendants and those who acted in concert with them) who purchased common stock of the Continental Illinois Corporation from July 6, 1982 (the ending date of a class certified in other proceedings relating to securities of the Corporation) through July 26, 1984, the date of the announcement by Federal regulators of the purchase of problem loans by the Federal Deposit Insurance Corporation (the "F.D.I.C.") from Continental Illinois Bank and Trust Company of Chicago (the "Bank") and the anticipated write down of its assets by $1 billion (the "class period").

3. Plaintiffs estimate that there are in excess of one thousand members of the putative class and that they are residents of many states.

4. Because the members of the class are so numerous and dispersed, joinder is impractical.

5. There are questions of law and fact common to the claims of all of the class members including:

(a) Whether defendants employed devices, schemes and artifices which defrauded purchasers of the Corporation's shares during the class period.

(b) Whether the financial statements and public announcements issued by the Corporation and the other defendants contained misstatements of material fact or failed to disclose material facts necessary to make the statements made not misleading.

(c) Whether the defendants (i) knew that the statements made were false, (ii) had knowledge of material facts which were not disclosed, or (iii) otherwise acted with the requisite intent, recklessness or negligence.

(d) Whether, and if so to what extent, the misstatements and omissions affected the market price of the Corporation's common stock during the class period.

6. Plaintiffs' claims are typical of the claims of other class members.

7. Plaintiffs' interests are not antagonistic to those of other class members and plaintiffs will fairly and adequately protect the interests of the class.

8. Plaintiffs' attorneys are experienced and capable in prosecuting securities class actions.

Defendants—Entities

9. (a) Defendant, the Corporation, is a Delaware corporation which maintains its principal place of business in Chicago, Illinois.

(b) The Corporation's common shares are publicly traded on the New York Stock Exchange and local exchanges.

(c) The Corporation is a bank holding company which owns all of the stock of the Bank except for qualifying shares. The Corporation and the Bank are referred to collectively as Continental.

10. Defendant, the Bank, is a national banking association with its principal place of business in Chicago, Illinois.

11. (a) Defendant Ernst & Whinney ("E & W"), is a partnership organized under the laws of Ohio, is engaged in the profession of accounting, and transacts business in Chicago, Illinois.

(b) During the class period and for many years prior thereto E & W was represented as acting as the independent accountants for Continental.

Defendants—Inside Directors and Management

12. (a) Defendant Roger E. Anderson was Chairman of the Board, chief executive officer and a director of Continental from before the beginning of the class period until February 1984.

(b) In February 1984 Anderson ceased to act as chief executive officer of Continental.

(c) On April 23, 1984, Anderson ceased to act as Chairman of the Board, and did not stand for re-election as a director of Continental.

13. (a) Defendant John H. Perkins was President and a director of Continental from before the beginning of the class period until February 1984.

(b) In February 1984 Perkins resigned as President of Continental.

(c) At the April 23, 1984 stockholders' meeting of the Corporation he did not stand for re-election as a director.

14. (a) Defendant Donald C. Miller was, from before the beginning of the class period until April 1984 a Vice-Chairman, and a director of Continental.

(b) At the April 23, 1984 stockholders' meeting of the Corporation, Miller did not stand for re-election as

a director of Continental, and as of that date he ceased to act as Vice-Chairman of Continental.

15. (a) Defendant David G. Taylor was, from before the beginning of the class period until August 1984, an Executive Vice-President of Continental.

(b) In August 1983 Taylor became a Vice-Chairman and a director of Continental.

(c) In February of 1984 he became chief executive officer of Continental.

(d) On April 23, 1984 Taylor became Chairman of the Board of Continental.

(e) On July 26, 1984 the F.D.I.C., the Federal Reserve Board and the Office of the Comptroller of the Currency issued a joint press release in which it was stated that Taylor was to resign from his previous positions with Continental effective August 13, 1984, and that he would serve as Vice-Chairman of the Bank.

16. (a) Defendant Edward S. Bottum was from before the beginning of the class period until February 1984, an Executive Vice-President of Continental.

(b) In August 1983, Bottum became a director of Continental.

(c) In February 1984 Bottum became President of Continental.

(d) On July 26, 1984 the F.D.I.C., the Federal Reserve Board and the Office of the Comptroller of the Currency issued a joint press release in which it was stated that Bottum was to resign his previous positions with Continental effective August 13, 1984 and that he would serve as a Vice-Chairman of the Bank.

17. Defendant George R. Baker was from before the beginning of the class period until his resignation on December 31, 1982 an Executive Vice-President of Continental.

18. (a) Defendant Gail M. Melick was from before the beginning of the class period until August 1983 an Executive Vice-President of Continental.

(b) On August 15, 1983 Melick was hospitalized and, shortly thereafter, took a medical leave.

(c) Melick retired from Continental in May 1984.

Defendants—Outside Directors

19. Defendant Raymond C. Baumhart, S.J., was, throughout the class period, a director of Continental.

20. Defendant James F. Bere was, throughout the class period, a director of Continental.

21. Defendant Weston R. Christopherson was, throughout the class period, a director of Continental.

22. (a) Defendant Robert A. Hanson was from before the beginning of the class period until April 1984 a director of Continental.

(b) Hanson did not stand for re-election as a director at the April 13, 1984 stockholders' meeting of the Corporation.

23. Defendant William B. Johnson was, throughout the class period, a director of Continental.

24. Defendant Jewel S. Lafontant was, throughout the class period, a director of Continental.

25. Defendant Vernon R. Loucks, Jr. was, throughout the class period, a director of Continental.

26. Defendant Frank W. Luerssen was, throughout the class period, a director of Continental.

27. Defendant Robert H. Malott was, throughout the class period, a director of Continental.

28. Defendant Marvin G. Mitchell was, throughout the class period, a director of Continental.

29. (a) Defendant Keith R. Potter was from before the beginning of the class period until April 1983 a director of Continental.

(b) Potter did not stand for re-election as a director at the April 25, 1983 stockholders' meeting of the Corporation.

30. Defendant John M. Richman was, throughout the class period, a director of Continental.

31. Defendant Paul J. Rizzo was, throughout the class period, a director of Continental.

32. Defendant Thomas H. Roberts, Jr. was, throughout the class period, a director of Continental.

33. Defendant William L. Weiss was, throughout the class period, a director of Continental.

34. Defendant Blaine J. Yarrington was, throughout the class period, a director of Continental.

Jurisdiction

35. Jurisdiction is conferred on this Court by virtue of:

(a) §27 of the Securities Exchange Act of 1934 (the "1934 Act"), 15 U.S.C. 78aa;

(b) § 22 of the Securities Act of 1933 (the "1933 Act"), 15 U.S.C. 77v;

(c) §1964(c) of the Racketeer Influenced and Corrupt Organizations Act ("RICO"), 18 U.S.C. §1964(c); and

(d) principles of pendent jurisdiction.

Factual Background

36. Prior to and during the class period, Continental pursued an aggressive marketing plan to increase the volume of the Bank's lending. During the period from 1975 through 1980, the Bank's assets grew at an annual rate of 15% and the annual growth continued thereafter at an annual rate of over 21%. The majority of the Bank's increased lending was in domestic credits but the Bank, striving to become a world class bank, extended its facilities

worldwide and extended significant loans to foreign countries. To support this phenomenal growth and as a result of a lack of credit controls, the Bank extended loans to companies and countries whose precarious financial conditions could not support repayment of the often huge sums extended and where the collateral for such sums, if any, was inadequate to assure repayment in the event of default. For example, the Bank lent $175 million to Nucorp Energy Inc., despite the Bank's knowledge that Nucorp's prior $100 million loan with the Bank had to be restructured due to financial difficulties. Nucorp filed for bankruptcy in July 1982.

37. Prior to the beginning of the class period, the Bank also purchased participations in energy loans originated by Penn Square Bank, N.A., ("Penn Square") in Oklahoma City, Oklahoma. These loans, for the most part, were not well secured and lacked adequate documentation and were extended in amounts, the repayment of which was not possible from either the operations or assets of the borrower or the purported guarantors of the loans or the purported collateral for the loans. By July 1982, the dollar amount of these participations reached $1 billion. Penn Square failed on July 5, 1982.

38. The Bank had difficulty funding its ever-increasing loan portfolio, lacking a stable source of deposits, caused, in part, by the absence of significant long-term deposits. Yet the Bank pursued its goal of becoming one of the biggest lenders in international banking circles and was compelled to rely heavily on short-term deposits, including overnight borrowings from other banks and 30-day certificates of deposit. As a result, the Bank became financially crippled as its source of money became more costly than the return it earned when it, in turn, lent the money to borrowers. It was not unusual for the Bank to lend

money at interest rates as much as 4% below its own cost of borrowing the money.

39. In mid-July 1982, the Bank withdrew its certificates of deposit from the so-called run of interchangeably traded certificates of deposit of major money center banks. The credit ratings of Continental's long-term debt were lowered by the two major rating agencies shortly after the failure of Penn Square, and were lowered once again near the end of the third quarter of 1982. As a result of these developments, Continental's funding flexibility was significantly reduced. Yet in Continental's 1983 Annual Report and Form 10K it stated that "[F]unding performance, our third fundamental, has held up well throughout this period . . ." and "the funding picture remains positive." Not until the release of Continental's August 1984 Proxy Statement was it disclosed that throughout the class period the Bank experienced increased costs of funding as a result of its severe problems. Moreover, not until March 1987 was the full extent of those problems publicly disclosed.

40. The financial condition of Continental and the Bank was further eroded by the unprofitability of many of its global operations which had been set up and operated at great cost to create the impression that Continental and the Bank were forces to be considered in international banking and business circles. As a result of these goals, lending officers were directed, and subjected to an atmosphere in which they were compelled, to lend money without regard for either the source of funding those loans or the cost of that funding.

The Scheme

41. (a) Subsequent to Penn Square's insolvency and closing, Continental, aided and abetted by the participation of E & W, embarked on a fraudulent course of ac-

tion, the objective of which was to promote the misleading impressions that (a) the Bank was financially sound and stable, (b) the Penn Square loan participations were unique and their poor credit quality was not reflective of the general condition of the Bank's loan portfolio, and (c) the adverse impact from Penn Square and other loan problems would be absorbed without material disruption to the Bank's underlying business condition, operations or strategies. In furtherance of this common course of conduct, Continental publicly stressed the Bank's strict standards for quality credits, its careful attention to credit control and its specific mechanisms for monitoring and maintaining the quality of the Bank's loan portfolio. In reality, such standards, controls and mechanisms were not yet in place and inadequate. For example, the Bank's computer system was badly outmoded and incapable of providing the requisite support to assure satisfactory, let alone exemplary, controls. The Bank's new loan evaluation committee did not even begin operating until after July 1983.

(b) Although aware of the inadequacies of the Bank's internal financial controls for the several years comprising the class period E & W, intentionally or by recklessness, failed to note and disclose such inadequacy or take steps to insist on remedial actions by the Bank and the Corporations.

42. (a) Prior to the beginning of the class period defendants, including E & W, became aware that a substantial amount of the receivables reported in Continental's financial statements were likely to be uncollectible.

(b) Prior to the class period the defendants, including E & W, became aware that the Continental was likely to incur a substantial losses by virtue of contingent liabilities including those arising from pending and threatened securities litigation.

(c) During the class period defendants, including E & W, were aware that an unusually large percentage of the Bank's deposits were for extremely short term (90% of all deposits due within 180 days) or demand deposits (50% of all deposits came due each day).

43. (a) The defendants, including E & W, did not want the perilous condition of Continental's finances to become publicly known.

(b) Defendants realized that should the true financial condition of Continental become known, an extraordinary portion of funds on deposit with the Bank would be withdrawn in a precipitous manner (i.e., there could be a "run" on the Bank) and its normal operations would be impaired.

(c) The defendants, including E & W, therefore, sometime prior to the beginning of the class period, entered into a scheme or conspiracy to conceal Continental's true financial condition (hereinafter referred to as the "Scheme").

(d) Defendant Taylor, as quoted in the July 30, 1984 Wall Street Journal said, "I don't think there was a quarter where we didn't debate whether we could take a big hit or not" and that "but because of our funding, we couldn't take a big loss."

44. (a) In furtherance of the Scheme, the defendants prepared, approved, certified and disseminated false and misleading financial statements relating to Continental's financial condition.

(b) Included among these statements were all of the Annual Reports and Forms 10-K, quarterly reports to shareholders, Forms 10-Q, press releases and public statements issued during the class period.

(c) In these statements the defendants overstated certain items, including loans receivable, lease financing receivables, net income, and retained earnings.

(d) In these statements defendants understated certain items, including reserve for credit losses, provision for credit losses, unearned income on loans, and the amounts of non-performing and problem loans.

(e) In the notes and comments accompanying the statements the defendants failed adequately to disclose:

(i) Loans which defendants had reason to know could not be collected or would not be repaid as scheduled;

(ii) Continental's contingent liabilities, including those arising from pending or threatened litigation;

(iii) Continental's susceptibility to run on its deposits;

(iv) the risk that Continental would be deprived of experienced senior management by reason of management's participation in the Scheme.

45. (a) During the class period the defendants authorized or permitted the payment of dividends of 50 cents per share each quarter, which was improper given Continental's undisclosed impaired financial condition.

(b) The payment of dividends was made in furtherance of the Scheme to deceive the public as to Continental's true financial condition.

(c) The Wall Street Journal reported on June 5, 1984 that defendant Taylor had resisted any cut in Continental's quarterly dividend saying that the payout was a signal to the financial markets of Continental's strength.

46. (a) In addition to its participation in and approval of the above enumerated actions, defendant E & W, with the knowledge, approval and encouragement of the other defendants, gave unqualified opinions on Continental's year-end financial statements and allowed the opinions to be

incorporated in Continental's Annual Reports and Forms 10-K for 1982 and 1983. For example, in the opinion attached to Continental's Annual Report and Form 10-K for the year ending December 31, 1983, E & W stated:

> "In our opinion, the financial statements referred to above present fairly the consolidated financial position of Continental Illinois Corporation and subsidiaries at December 31, 1983 and 1982, and the consolidated results of their operations and the changes in their financial position for each of the three years in the period ended December 31, 1983, and the consolidated financial position of Continental Illinois National Bank and Trust Company of Chicago and subsidiaries at December 31, 1983 and 1982, all in conformity with generally accepted accounting principles applied on a consistent basis."

Contrary to the above statements, the aforesaid financial statements were false and misleading and not prepared in conformity with generally accepted accounting principles, with standards of fair reporting or in full compliance with the federal securities laws, and the aforesaid audits were not conducted in accordance with generally accepted auditing standards.

(b) The 1982 and 1983 opinions of E & W were false, since, in part, Continental's financial statements overstated receivables, income and net worth; understated reserves and charges against income; and failed adequately to disclose Continental's contingent liabilities. The financial statements did not fairly reflect Continental's financial condition or the results of its operations.

(c) The financial statements of Continental, certified by E & W, disseminated in its 1982 Annual Report and Form 10-K, contained material overstatements of assets and income and understatements of non-performing loans and reserves for credit losses:

(i) At Annual Report page 22, provisions for credit losses were stated at $492 million, which failed to reflect the material amounts of credits for which reserves should have been taken, in additional amounts of at least $600 million.

(ii) At page 22, net credit losses of $393.2 million were materially understated by approximately $4 billion in bad loans.

(iii) At page 22, non-performing loans were reported at approximately $1.9 billion which materially understated the amount of loans which were not performing or which had been restructured to give the illusion that they were currently meeting obligations. At page 23, Continental falsely stated that this category should improve in 1983 with "repayment in many cases." In reality, the vast majority of the Bank's non-performing loans were not capable of repayment or were not capable of significant repayment.

(iv) At page 32, Continental overstated the asset value of its loan portfolio by at least $4 billion.

(v) At page 33, Continental's net interest income after provision for credit losses was overstated by at least $600 million. If provisions for credit losses had been properly calculated based on the condition of the Bank's loan portfolio and not on Continental's desire to show a profit, Continental would have reported a loss for the year.

(d) The 1983 Continental financial statement, the 1983 Annual Report and Form 10-K in which financial statements appeared, certified by E & W, contained ma-

terial overstatements of assets and income and understatements of non-performing loan and reserves for credit losses:

(i) E & W continued to certify financial statements which overstated Continental's assets by at least $4 billion, and to understate its reserves for credit losses by at least $600 million and to overstate its income in a corresponding amount for the year ended December 31, 1983.

(ii) Throughout 1983, defendants, including E & W, failed to disclose that the Bank entered into an agreement with the Comptroller to address certain matters arising from the Comptroller's 1982 examination of the Bank. Under this agreement, the Bank was required to continue implementation and maintenance of new and strengthened plans, policies, and procedures designed to improve overall performance in accordance with the Bank's revised corporate objectives, and to report periodically on such matters to the Comptroller.

(iii) In Continental's 1983 Annual Report and Form 10-K, disseminated in March 1984, E & W failed to disclose that Continental's problem loans were not confined to either Penn Square Bank participations or energy-related credit but permeated the Bank's portfolio and reached amounts approximating $4 billion. For example, of the loans written off by Continental in 1983 and 1984, more than 40% were not related to the oil and gas industry and of the net credit losses reported

in 1983, 65% were not related to Penn Square participations.

(iv) Continental's 1983 Annual Report and Form 10-K, at page 8, stressed its "very large and loyal customer base," and that "[w]e can have every confidence that our customers will stay with us." These statements failed to disclose that Continental's customer base already had begun to erode materially and that many significant large depositors were withdrawing their funds and that other major depositors who did agree to keep big deposits in the Bank insisted on very short maturities to allow them as much liquidity as possible.

(v) Defendants, including E & W, failed to disclose that during 1983 Continental had retained Goldman, Sachs & Co. to determine methods by which the Bank could rid itself of undisclosed problem loans by selling off the loan or forming a new corporation, a drastic course of action which was reflective of undisclosed, critical problems in the financial condition of Continental and the Bank.

(vi) Even after attributing a $425 million loss on sale of loans subject to the F.D.I.C. agreement (which attribution was false and misleading), the provision for losses in the second quarter 1984 was more than one-half billion dollars for the quarter, and the total credit loss (which did not include any loss on the sale of loans subject to the F.D.I.C. agreement), was nearly 150% more than the net credit losses Continental had recognized in

the four prior periods (that is one fiscal year) put together. Most, if not all, of the $629 million in credit losses recognized in the second quarter of 1984 should have been recognized in earlier quarters, and E & W knew or but for its recklessness should have known that without the recognition of these net credit losses in earlier periods the financial condition of Continental in public filings was distorted, artificially inflated and materially misleading. In fact, the $425 million loss was also due to credit losses and also should have been recognized in earlier periods, which fact should have been disclosed.

(vii) Non-performing loans increased by over 42% between the fourth quarter 1983 and the second quarter 1984, from $1.964 billion as of December 31, 1983 to $2.759 billion as of June 30, 1984. Of this nearly $800 million increase in non-performing loans, nearly one-third, or $260 million, were mortgage and real estate loans. E & W, in order to avoid the adverse effect on earnings of non-performing credits (classifying a loan as non-performing results in all previously received accrued interest being reversed out of income), certified financial statements misrepresenting the true non-performing credit status of the Bank's loan portfolio, concealing non-performing loans by means of deceptive maturity extensions, rate concessions, "roll-overs" and other means, or otherwise recklessly disregarded the true condition of the Bank's loan portfolio with respect to such non-performing loans.

(viii) E & W failed to disclose that Continental's and the Bank's loan acquisition program had been increasingly unmanageable, that Bank personnel had engaged in loan transactions with borrowers in non-energy related areas where the borrower's ability to repay the loans was improbable or where the collateral for the loans was not sufficient to repay the loan and that Bank personnel were not being adequately supervised, controlled, directed or accounted for by Continental, the Bank or the defendants.

(ix) E & W knew or but for its recklessness would have known that the Bank's deposit base made it extraordinarily susceptible to interest rate changes. In addition, E & W knew or recklessly disregarded the fact that the short-term nature of the Bank's deposits jeopardized the Bank's ability to achieve a steady level of net interest income and rendered impotent the Bank's efforts to manage interest-sensitive gaps to avoid exposure risks. E & W further failed to disclose the Bank's cost of funding increased throughout the class period as a result of extraordinary steps taken to secure funding. These facts were withheld by defendants until the deposit runoff during the second quarter 1984.

(e) Further, Continental's financial statements were not prepared in conformity with generally accepted accounting principles applied on a consistent basis, in that *inter alia*;

(i) The defendants had overstated Continental's receivables. Financial Accounting Standard No. 5 promulgated by the Financial Account-

ing Standards Board of the American Association of Certified Public Accountants ("FAS No. 5") required that a substantial portion of Continental's receivables be reduced by an accrued loss because the information available to the defendants indicated that it was probable that some of the receivables had been impaired and because the amount of such impairment could be reasonably estimated.

(ii) The defendants failed to adequately disclose in Continental's financial statements or the accompanying notes the amount of receivables, the terms of which had been modified, and the change in income resulting from the modification as required by FAS No. 15.

(iii) Defendants failed to adequately disclose in Continental's financial statements and accompanying notes the aggregate amount of loans outstanding at the end of 1982 and 1983 which were being held on a non-accrual basis, were past due, restructured or were potential problem loans as required by S.E.C. Regulation S-X, 17 C.F.R. §210.1-01, *et seq.* and Industry Guide 3, 76 Fed.Reg. 26,837 (1976).

(iv) Defendants, in the notes accompanying Continental's financial statements, failed to adequately describe the nature and extent of those loans about which management had serious doubts of the debtor's ability to comply with the loan terms as required by S.E.C. Industry Guide 3, 76 Fed.Reg. 36,847 (1976). See also S.E.C. Industry Guide 61, 76 Fed.Reg. 26,837 (1976).

(v) Defendants failed to adequately disclose Continental's contingent liability arising out of pending or threatened litigation in violation of FAS No. 5.

(vi) E & W certified Continental's credit loss reserves as being calculated in conformity with generally accepted accounting principles when the application of generally accepted auditing standards would have revealed that they were grossly understated because of their failure to reflect the loan problems as alleged herein.

(vii) E & W failed to assure compliance with SEC Regulation S-X, 17 C.F.R. §210.9-02, which requires bank holding companies, in their 10-K, to disclose any unusual risk concentration of loans, which concentration with respect to the Penn Square loans, as previously alleged, was not disclosed in the 1981 Form 10-K.

(b) Additionally, defendant, E & W, acted in furtherance of the Scheme by failing to correct materially inaccurate annual and interim financial statements promulgated by Continental.

47. The foregoing false and misleading statements and omissions, as hereinbefore alleged, were material, and were made with knowledge of their falsity or with reckless disregard for the truth. Through its actions, E & W by itself, and aiding and abetting others, engaged in acts, practices and courses of business which operated to inflate artificially the market price of Continental Illinois stock. In ignorance of the adverse factors concerning Continental Illinois' and the Bank's business and financial condition concealed by E & W, and relying on E & W's

material misstatements and omissions and/or on the integrity of the market for the Corporation's securities, class plaintiffs and the members of the class purchased the Corporation's common stock at artifically inflated prices and suffered damages in an amount presently undetermined.

48. (a) Throughout the class period, E & W continually certified artificial net income figures for Continental. After the reported loss for the second quarter of 1982, which Continental had attributed solely to Penn Square, defendant E & W certified significant net profits for Continental as follows:

PERIOD	NET PROFIT ($ MILLION)
Year End 1982	$ 78
Year End 1983	$108

(b) Not until the second quarter of 1984 did Continental report a net loss. The net loss for that period was reported to be $1.6 billion.

(c) E & W failed to disclose that Continental could not recover, either slowly or quickly, from the inherent problems of its loan portfolio, lack of controls, and serious funding difficulties. The 1982 financial statement certified by E & W and subsequent interim statements further misstated that provisions for credit losses and credit charge-offs were expected to decline in 1983. E & W failed to disclose that profitability could be maintained only if required loan charge-offs and reserves for credit losses were not taken and that the historical quarterly dividend could be maintained only if Continental refused to recognize losses. E & W failed to disclose that Continental's financial condition also was seriously impaired by the bad loans contained in its portfolio which no change in economic conditions could materially improve. As the subse-

quent domestic and worldwide economic recoveries in 1983 and 1984 revealed, improvement in economic conditions could not alter the Bank's disastrous financial condition.

49. Throughout the class period E & W certified an artificially low and stable dollar volume of non-performing loans. Not until the second quarter of 1984 did Continental report a 25% increase to $2.7 billion in such loans. Throughout the class period E & W helped create the illusion except for the Penn Square portfolio that the Bank's loan portfolio was healthy. Finally in the second quarter of 1984 Continental reported a more than 500% jump in net credit losses to $626 million. In fact, the actual jump in net credit losses was $425 million more than that, a fact never publicly disclosed by defendants.

50. In sharp contrast to Continental's glowing public projections for a 79% increase in operating earnings and a 26% reduction in problem loans, announced in the winter of 1982-83, conditions worsened within Continental and the Bank. In or about September 1983, Continental formally retained Goldman, Sachs & Co., its investment banker, to determine ways in which Continental could dispose of many of the Bank's non-performing loans, either through sale or by spinning off the bad loans to a new corporation. Goldman Sachs' unsuccessful efforts in this regard, undisclosed to the public by Continental or any defendant, continued throughout the remainder of the class period.

Unravelling of the Scheme and Continued Attempts at Concealment

51. (a) In 1984, reports began to circulate in the financial community that Continental's financial condition was worse than had been reported in Continental's financial statements. Defendants sought to discredit reports of Continental's impaired financial condition and continued

the Scheme to conceal Continental's imperilled financial position.

(b) On April 18, 1984 it was publicly reported that there had been a 21% increase in the Bank's non-performing or problem loans from a total of $1.9 billion to $2.3 billion during the first quarter of 1984. Defendants did not disclose that these loans had been problem loans since prior to the class period, that defendants were seeking to disclose problem loans gradually because they feared that accurate disclosure of problem loans would cause a run on the Bank's deposit and that there were a great number of problem loans which still had not yet been disclosed.

(c) On April 24, 1984 the Bank announced that problem loans might exceed the $2.3 billion figure reported the previous week. The announcement was based on information available eight days previously, when the April 18, 1984 report was issued. The defendants did not disclose that Continental had more than $5 billion in problem loans.

(d) On May 11, 1984 it was publicly reported that a number of large depositors including the Chicago Board of Trade Clearing Corporation were withdrawing their deposits from the Bank. It was also publicly reported that the Corporation's stock and debt securities "took a pounding in heavy volume trading spurred by rumors that the Bank's financial condition has worsened."

(e) In an effort to continue the Scheme, and to reverse the run on the Bank's deposits, defendant Taylor said:

> "The rumors circulating about the possible bankruptcy, merger or acquisition of Continental [have] no basis in fact and never should have been fueled by irresponsible wire service reports."

(f) On May 11, 1984, it was publicly reported that the Bank had steadfastly denied that it was having trouble gathering deposits and had asserted that it had not sought assistance from other banks or from regulators.

(g) The effect of the statements referred to in the foregoing sub-paragraphs was to inflate artificially the prices of the Corporation's shares.

(h) On May 17, 1984, Continental announced that the F.D.I.C., the Federal Reserve Board and the Comptroller of the Currency, together with a group of banks had agreed to provide a program of financial assistance for Continental "for the period of time necessary to enhance the Bank's permanent capital, by merger or otherwise." As part of the program:

(i) The F.D.I.C. and a group of commercial banks would provide $2 billion in capital to Continental in the form of subordinate notes;

(ii) The group of banks agreed to provide $5.3 billion in funding for Continental on an unsecured basis.

(iii) The Federal Reserve stated that it was prepared, in accordance with customary arrangements, to meet any extraordinary liquidity requirements of the Bank.

(iv) The F.D.I.C. provided assurances that, in any arrangements that might be necessary to achieve a permanent solution, all depositors and general creditors would be fully protected.

(j) On May 21, 1984 it was publicly reported that:

(i) First Chicago Corporation was considering making a bid for the Bank.

(ii) Citicorp had obtained non-public information in connection with a possible purchase of the Bank.

(iii) The chief attorney for Chemical Bank was in Chicago meeting with Bank officials. However, defendants did not disclose that the large amount of uncollectible loans in Continental's portfolio and Continental's inadequately disclosed liabilities which the defendants had concealed would make any merger impossible.

52. Even these extraordinary measures by the F.D.I.C. were unavailing in view of the magnitude of the financial difficulties of Continental and the Bank. Continental sought merger partners who, one by one, rejected the overture upon examination of publicly undisclosed information relating to Continental's and the Bank's loan portfolio and financial condition. Finally, the F.D.I.C. was forced to offer its own rescue plan. On July 26, 1984, the F.D.I.C., the Federal Reserve, Continental, and the Bank entered into an agreement in principle setting forth a plan providing assistance to the Bank and the restructuring of Continental. The plan was designed to deal with "the earnings, asset quality, and funding problems experienced by the Bank since the failure of Penn Square Bank on July 5, 1982 . . ." A critical element of the plan was that the Bank would sell to the F.D.I.C. for $2 billion nonperforming, classified and other poor quality loans (collectively "poor quality loans") with a book value of $3 billion at May 31, 1984, and that the Bank would issue a three-year note to the F.D.I.C. in the amount of $1.5 billion, which could be satisfied by the delivery to the F.D.I.C. in or during the three years following the effective date of the plan of additional poor quality loans on the Bank's books at May 31, 1984, with a book value on that date of up to $1.5 billion. In consideration of these transfers by the Bank and the Corporation, the F.D.I.C. would assume a debt of $3.5 billion owed by the Bank

to the Federal Reserve. The plan was approved by the holders of Continental common stock. The F.D.I.C. had announced that if the plan was rejected by the stockholders, the federal financial assistance would be withdrawn and would result in a declaration of the Bank's insolvency from a liquidity standpoint and that the failure of the Bank would almost inevitably result in the insolvency of Continental and the loss of the stockholders' common stock investment.

53. In furtherance of the Scheme, on June 13, 1984 defendant Taylor was reported as saying that the unprecedented multi-billion dollar run on the Bank had been triggered by false rumors and irrational fears. It was also reported that Chemical Bank was no longer interested in acquiring Continental and that it had discussed some of its findings regarding Continental with the Federal Reserve Board and the F.D.I.C. Defendants did not disclose that said decision resulted from Chemical Bank having determined, through a review of Continental's books, that there had been a gross overstatement of Continental's net worth.

54. On June 21, 1984 it was publicly reported that the S.E.C. had expanded its investigation of Continental to examine the adequacy of the company's loan-loss provisions over the past several years. Defendants still did not disclose that there was a gross overstatement of Continental's net worth as a result of the Scheme.

55. On June 23, 1984 it was publicly reported that the Bank's problem loans could amount to $4 billion rather than $2.3 billion as had been reported earlier.

56. On July 3, 1984 it was publicly reported that bankers were shocked to learn that 90% of the Bank's deposits had to be repaid within six months and that 50% had to be repaid each day. This meant that each day the Bank had to borrow $20 billion from banks and other world

organizations. Continental's and E & W's failure to disclose said facts constituted part of the Scheme.

57. On July 26, 1984, the F.D.I.C., the Federal Reserve Board and the Office of the Comptroller of the Currency announced that the F.D.I.C. would purchase loans from Continental, which had a face value of $5.1 billion and a book value of $4.5 billion, for $3.5 billion. If the plan was approved by the Corporation's shareholders:

(i) As a result of the purchase, Continental would realize a $1 billion loss.

(ii) The F.D.I.C. would purchase newly issued preferred stock in Continental for $1 billion.

(iii) The preferred stock would be convertible at the F.D.I.C. option into 160 million newly issued common shares in Continental.

(iv) This would greatly dilute the present shareholders' holdings as the F.D.I.C. would then own 80% of Continental's common stock.

(v) The F.D.I.C., under the plan, would also be able to acquire the other stockholders' common shares in the Corporation for a nominal amount in order to cover any losses it might sustain under the loan purchase.

58. The defendants' Scheme, including misstatements and omissions prior to July 26, 1984, misled numerous investors and market analysts so that the price of the Corporation's stock was vastly inflated during the period when class members were purchasing their stock.

59. (a) Continental announced that it would have a loss in excess of $1 billion for the second quarter of 1984 and delayed issuing its quarterly report. Its common stock plunged below $3 a share. On August 6, 1984, Continental reported an expected $1.16 billion second quarter loss.

(b) On August 13, 1984, Continental issued its Form 10-Q for the second quarter 1984. The Form 10-Q

stated that the volume of the Bank's non-performing loans and lease receivables "will be very substantially reduced" after the sale of $3 billion of loans and lease receivables to the F.D.I.C. (and further sales, over the period of three years after the effective date, pursuant to the provision for transfer to the F.D.I.C., at the Bank's election of up to a further $1.5 billion in poor quality loans and lease receivables). The magnitude of the Bank's non-performing loans as of May 31, 1984, was such that the transfer of $3 billion through the plan would not be sufficient to transfer to the F.D.I.C. all problem loans and this suggested that the poor quality loans far exceeded $3 billion as of May 31, 1984, since after major charge-offs and loan loss provisions for the second quarter 1984, non-performing loans equalled $2.7 billion.

60. For the second quarter 1984, as reflected in the Form 10-Q, defendants made the following provisions and experienced the following net credit losses in its financial statements:

(i) It began the period with a total of $401 million reserve for credit loss.

(ii) It made a new provision for credit losses totalling $990 million.

(iii) It recognized credit losses of $629 million.

(iv) A total end-of-period reserve for losses of $762 million (of which $425 million was reported as a loss on the sale of loans subject to the F.D.I.C. agreement). Effectively, this left a credit loss reserve of $337 million at the end of the period.

(v) In fact, the $425 million loss was not a loss on the sale of loans subject to the F.D.I.C. agreement, but rather additional undisclosed credit losses which should have been disclosed under generally accepted accounting principles.

61. E & W herein either had actual knowledge of the materially false and misleading nature of the statements and omissions set forth above, or acted with reckless disregard for the truth in failing to ascertain and disclose the material facts or aided and abetted the unlawful conduct alleged herein. Through its activities as the certified public accountant and auditor of Continental and the Bank, E & W participated in preparing or reviewing the materially misleading documents described above, and authorized and/or certified particular misleading financial statements described above. Furthermore, E & W had intimate knowledge of the financial condition of the Bank and Continental and participated in, *inter alia*, the determination of the amount of reserves for credit losses. In addition, E & W knew of the costs of Continental's borrowings, the lack of adequate controls and the negotiations with Goldman, Sachs. E & W also participated in the preparation of the financial statements of Continental. As a result, E & W helped determine the publicly disseminated asset values and net income figures for Continental and the Bank.

62. The alleged misstatements and omissions were material. Subsequent to the disclosure of the F.D.I.C. "bail out," at the end of the class period, the market price of Continental common stock dropped to below $3 per share, down from as much as $24-7/8 per share during the class period.

63. The alleged misstatements and omissions operated to inflate artificially the market prices of Continental Illinois' common stock and constituted an artificial impairment of the integrity of the market.

64. In ignorance of the adverse facts concerning the business and financial condition of Continental and the Bank concealed by E & W, and relying on E & W's material misstatements and omissions and/or on the integrity

of the market for the common stock of Continental, plaintiffs and the members of the class purchased Continental common stock at artificially inflated prices and suffered damages in an amount presently undetermined.

COUNT I - 1934 Act

65. By reason of the foregoing, the defendants, in connection with the purchase of Continental's common stock, each aided and abetted by the others and acting knowingly or with reckless disregard for the truth, acted in violation of §10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b) and Rule 10b-5 promulgated thereunder by the S.E.C., 17 C.F.R. §240.10b-5, through the use of instrumentalities of interstate commerce by:

(a) employing devices, schemes and artifices to defraud;

(b) by making untrue statements of material fact and/or omitting to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; and

(c) engaging in transactions, practices or courses of business which operated as a fraud or deceit upon the members of the plaintiff class.

66. WHEREFORE, the plaintiff pray that this Court:

(a) Enter judgment, in favor of the plaintiffs and the plaintiff class and against the defendants, for the damages sustained by the plaintiffs and the plaintiff class.

(b) Award the plaintiff the costs and expenses of this action, including reasonable attorneys' fees.

(c) Grant such other and further relief as the Court finds is just under the circumstances.

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(2)

No. 90-416

FILED
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1990

ROCCO DILEO and LOUISE DILEO,

Petitioners,

v.

ERNST & YOUNG,

Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED

Did the Court of Appeals correctly conclude that the factual allegations in the amended complaint failed to allege fraud with sufficient particularity as required by Rule 9(b) of the Federal Rules of Civil Procedure?

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ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

Respondent Ernst & Young ("E&Y") requests that this Court deny the petition for writ of certiorari, seeking review of the judgment of the Court of Appeals for the Seventh Circuit. (A1-A10).* Petitioners ask this Court to review the allegations in their complaint and determine whether they have pleaded securities fraud with the particularity required

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* Citations to "A__" are to the Appendix accompanying the petition.

by Rule 9(b) of the Federal Rules of Civil Procedure. Despite an abundance of available information and an opportunity to replead,* three courts have reviewed petitioners' initial and amended pleadings and concluded they were insufficient under Rule 9(b). No question of law, much less a conflict among the circuits, is presented, but only the application of established principles to these particular allegations.

STATEMENT OF THE CASE

The amended complaint alleging securities law violations, on behalf of a putative class of purchasers, was brought against Continental Illinois Corporation ("Continental"), various officers and directors, and E&Y. The initial complaint was dismissed, pursuant to Rule 9(b), with leave to amend. Class certification was denied because the alleged class duplicated a previously certified class, which had settled. (A13-A14). E&Y moved to dismiss securities fraud, RICO, and common law fraud claims asserted against E&Y in the amended complaint; that motion was granted and the amended complaint was dismissed as against E&Y. Petitioners did not appeal the dismissal of the RICO and common law fraud claims. The only issue decided by the Seventh Circuit

* In dismissing petitioners' initial complaint against E&Y for failure to plead fraud with particularity, the district court noted that petitioners' failure to state their fraud claims with particularity was magnified by the fact that they "had access to discovery sufficient to allow them to plead with excellent specificity. The issues sought to be raised here were the subject of discovery in other cases and [E&Y's] general role in the Continental Bank affair was tried on the merits before Judge Grady of this Court in the Continental Illinois securities litigation [in which a jury rendered a verdict for E&Y]." *DiLeo* v. *Baumhart*, No. 84C7305, slip op. at 2 (N.D. Ill. May 2, 1988).

was the dismissal of the securities claims for failure to plead fraud with the particularity required by Rule 9(b).

The Court of Appeals carefully analyzed the amended complaint and distilled the allegations down to the essentials. (A4-6). The petition in this Court does not dispute the Court of Appeals' summary of those allegations.

Petitioners were shareholders of Continental. Respondent E&Y was Continental's independent auditor for the 1982 and 1983 fiscal years. The value of petitioners' shares fell as various loans in Continental's loan portfolio defaulted, and as Continental was required to raise its reserves for bad loans. The gist of petitioners' complaint was that Continental did not increase its reserve for bad loans quickly enough, and that E&Y "became aware that a substantial amount of the receivables reported in Continental's financial statements were likely to be uncollectible." (A4). As the Court of Appeals pointed out, however, the complaint failed to connect E&Y with any particular fraud:

> "The story in this complaint is familiar in securities litigation. At one time the firm bathes itself in a favorable light. Later the firm discloses that things are less rosy. The plaintiff contends that the difference must be attributable to fraud. 'Must be' is the critical phrase, for the complaint offers no information other than the differences between the two statements of the firm's condition .... *It presents nothing other than the change in the stated condition of the firm to suggest that [E&Y] was so much as negligent in auditing Continental's financial statements.*" (A6) (emphasis supplied).

The Court of Appeals affirmed dismissal of the amended complaint, discussing separately the two legal theories upon which petitioners relied below. First, the court affirmed

dismissal of the claim of primary liability under the securities laws (*i.e.*, E&Y's certification of Continental's financial statements) because E&Y's alleged fraud was not pleaded with particularity. (A3-A6). "Rule 9(b) required the district court to dismiss the complaint, which discloses none of the circumstances that might separate fraud from the benefit of hindsight." (A6).

> "You cannot tell from reading it why the DiLeos believe that the problems were so apparent that reserves should have been jacked up before the end of 1983 - why failure to increase the reserves amounted to 'fraud'. Fed. R. Civ. P. 9(b) requires the plaintiff to state 'with particularity' any 'circumstances constituting fraud'. Although states of mind may be pleaded generally, the 'circumstances' must be pleaded in detail. This means the who, what, when, where, and how: the first paragraph of any newspaper story. None of this appears in the complaint, although the flood of information released about Continental Bank since 1984 offers ample fodder if there is indeed a tale to tell." (A5-A6)

In affirming dismissal of the amended complaint for "direct" fraud by, or primary liability of, E&Y, the court did not mention, let alone address, the complaint's general allegation of scienter. (*See* A3-A6).

The Court of Appeals also addressed petitioners' claim that E&Y was secondarily liable under the securities laws for "aiding and abetting" the primary fraud of Continental (*i.e.*, E&Y's alleged failure to disclose Continental's fraud to the petitioners). The court affirmed the dismissal of this claim on two independent grounds: first, petitioners had not alleged an essential element of aiding and abetting liability (A8); and second, petitioners had failed to allege facts to suggest that

E&Y acted with the requisite scienter (A8-A10). Only the second of these grounds is questioned in the petition.

REASONS WHY THE PETITION SHOULD BE DENIED

The petition should be denied. There is no conflict among the circuits concerning the "particularity" requirement of Rule 9(b) in fraud cases, even assuming that "particularity" constitutes an issue of sufficient national importance to suggest the necessity of the discretionary intervention of this Court. Rather, the only issue presented by the petition is whether the Court of Appeals correctly applied Rule 9(b) to the specific factual allegations in this complaint. Two courts have already conducted this fact-bound effort, and no justification exists for this Court to perform a third review. *Cf. Graver Tank & Mfg. Co.* v. *Linde Air Products Co.*, 336 U.S. 271, 275 (1949). Similarly, with respect to the allegation of scienter, review by this Court is unwarranted because petitioners have not sought review of the primary ground advanced by the Court of Appeals for dismissal of the pleading, and because the asserted conflict among the circuits does not implicate the decision below.

1. Whether these allegations meet the "particularity" requirements of Rule 9(b) is a fact-based issue, correctly decided, and not worthy of review by this Court.

The first issue addressed by the Court of Appeals was whether petitioners' allegations of E&Y's asserted direct or primary fraud in certifying the financial statements met the "particularity" requirement of Rule 9(b). The court reviewed those factual allegations in detail (A3-A4), and concluded, as quoted at pages 3-4, *supra*, that E&Y's alleged fraud had not been set forth with "particularity."

Petitioners suggest (Pet. at 8-10) that the Court of Appeals' explanation of the deficiency in this pleading - its failure to set forth the "who, what, when, where, and how" of E&Y's asserted fraud (A5) - constitutes a conflict among the circuits. Petitioners assert that other circuits "*require only* identification of the time, place and nature of the fraudulent conduct." Pet. at 9 (emphasis supplied). But petitioners cannot construct a conflict among the circuits by juxtaposing "who, what, when, where, and how" against "time, place, and nature." That is especially true because petitioners do not attempt to explain how the disposition here, based on the allegations in the amended complaint, would be any different even if the Court of Appeals had applied the allegedly "different analysis" urged by them.

As shown by the cases petitioners cite, a detailed analysis of the factual allegations of the particular complaint is the heart of a Rule 9(b) analysis. For example, in *Christidis* v. *First Pennsylvania Mortgage Trust*, 717 F.2d 96 (CA 3 1983), Pet. at 6, the complaint alleged that the Trust's reported reserve for bad loans was understated and that defendants (including an accounting firm) knew that deceptive accounting measures disguised the Trust's true financial condition. As in this case, the loans apparently went bad and plaintiffs lost money. The court affirmed dismissal of the complaint pursuant to Rule 9(b) because it did not disclose "the manner in which, in establishing reserves for bad debts in the financial statements relied upon, the defendants knowingly departed from reasonable accounting practices." *Id.* at 100. *See also*, cited in Pet. at 6, 9, *Seattle-First National Bank* v. *Carlstedt*, 800 F.2d 1008, 1012 (CA 10 1986) (Moore, *J.*, dissenting) (agreeing with majority's legal analysis of Rule 9(b), but disagreeing with majority's application of it to the factual allegations of the complaint).

The Court of Appeals did not, as petitioners suggest (Pet. at 9), create any "pleading standard" that Rule 9(b) requires the pleading of evidence. In illustrating the deficiency of this pleading in failing to "particularize" the "circumstances" of E&Y's asserted fraud, the court merely observed that the complaint did "not [refer to] a single concrete example" of a "reserve" that should have been taken, a "bad loan," or a "non-performing loan." (A4). Far from creating a new "pleading standard" (Pet. at 9), the decision of the Court of Appeals simply sifted through the allegations in this complaint, concluded that the circumstances of E&Y's asserted fraud had not been set forth with particularity, and applied the general rule that conclusory allegations of fraud are insufficient. *See, e.g., Craighead* v. *E.F. Hutton & Co.*, 899 F.2d 485, 489 (CA 6 1990); *Smith* v. *Ayres*, 845 F.2d 1360, 1365 (CA 5 1988); *Semegen* v. *Weidner*, 780 F.2d 727, 731 (CA 9 1985); *Hayduk* v. *Lanna*, 775 F.2d 441, 444 (CA 1 1985); *Utah State University* v. *Bear, Stearns & Co.*, 549 F.2d 164, 170-71 (CA 10), *cert. denied*, 434 U.S. 890 (1977).

2. Whether there is any conflict concerning the allegation of scienter under Rule 9(b) is not a question presented by this petition or implicated by the decision below.

The Court of Appeals next addressed the insufficiency of petitioners' allegations in this complaint that E&Y was secondarily liable under the securities laws for assertedly aiding and abetting the primary fraud of Continental. (A6-A10). In the context of secondary liability, the court wrote that this complaint did not provide any "basis for believing that [petitioners] could prove scienter." (A9). From that reference, petitioners assert that the Seventh Circuit adopted a Second Circuit standard of pleading scienter, which conflicts with other circuits, and should be resolved by this Court. Pet. at 7-8.

Before addressing the question of procedure raised in the petition, we observe that an alternative ground for the judgment exists as to which petitioners have not petitioned for review. Petitioners' underlying claim against E&Y was for assertedly aiding and abetting. We note that the Court would initially have to decide the substantive issue, twice specifically reserved by the Court, of whether there is aiding and abetting liability at all under § 10(b) of the Securities Exchange Act and Rule 10b-5. *See Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 191 n.7 (1976); *Herman & Maclean* v. *Huddleston*, 459 U.S. 375, 379 n.5 (1983).

Assuming arguendo for purposes of this brief only that such liability exists,* petitioners fail to mention that the court below affirmed the dismissal of the complaint for two separate and independent reasons. The court first held that the complaint failed to allege an essential element of aiding and abetting liability (some legal or factual basis that E&Y owed a duty to inform petitioners of Continental's primary fraud). (A6). Petitioners did not seek review of that determination. Because this ground—the first discussed by the Court of Appeals—is conclusive of this case without even reaching the Rule 9(b) issue that the petition seeks to raise, review by this Court is inappropriate and unnecessary. *Cf. New York* v. *Uplinger*, 467 U.S. 246 (1984) (certiorari dismissed as improvidently granted); *The Monrosa* v. *Carbon Black Export, Inc.*, 359 U.S. 180 (1959) (same).

With respect to the procedural question petitioners present, the court's additional ground for dismissing this claim, that petitioners failed to allege any facts suggesting scienter in a

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* E&Y, in support of the judgment below, would argue that there can be no liability for aiding and abetting under § 10(b) and Rule 10b-5.

secondary liability context, does not warrant review by this Court. Petitioners' suggestion that the Court of Appeals adopted a Second Circuit interpretation of Rule 9(b), which they contend conflicts with the Third and Tenth Circuits' interpretation of the Rule, is a house of cards.

We note initially that the Court of Appeals did not purport to join the Second Circuit in any unique position regarding the pleading of scienter and did not cite or rely on a single Second Circuit decision on this issue. If in fact a conflict exists between the Second Circuit and other courts of appeals, the Court will have enough time to resolve the issue in a case squarely adopting the Second Circuit's assertedly different approach.* Finally, even assuming Second Circuit decisions might conflict with those of other circuits where primary liability is involved, the court below did not adopt (or purport to do so) a rule requiring the pleading of facts supporting an inference of scienter in primary liability cases. Rather, in the context of a claim of secondary liability under the securities

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* We also note that the asserted conflict appears to be more a matter of semantics than results. The Second Circuit recognizes that "it would be unworkable and unfair to require great specificity in pleading scienter, since 'a plaintiff realistically cannot be expected to plead a defendant's actual state of mind.'" *Stern* v. *Leucadia National Corp.*, 844 F.2d 997, 1004 (CA 2) (quoting *Connecticut National Bank* v. *Fluor Corp.*, 808 F.2d 957, 962 (CA 2 1987)), *cert. denied*, 488 U.S. 852 (1988). The court requires that "circumstances must be pleaded that provide a factual foundation for otherwise conclusory assertions of scienter." *Id. See also Ross* v. *A.H. Robins Co.*, 607 F.2d 545, 558 (CA 2 1979), *cert. denied*, 446 U.S. 946 (1980). Although that formulation of the Rule apparently is unique to the Second Circuit, it merely amplifies Rule 9(b)'s first requirement that the *circumstances* of the fraud be pleaded with particularity; if the circumstances are so pleaded, a general averment of scienter will suffice in any circuit. *See, e.g.*, *Cosmas* v. *Hassett*, 886 F.2d 8, 12-13 (CA 2 1989); *Goldman* v. *Belden*, 754 F.2d 1059, 1069-70 (CA 2 1985).

laws, the court determined that petitioners' pleading, including its averment of scienter, was insufficient under Rule 9(b) because it failed to connect E&Y with any fraud by Continental and because petitioners' conclusory aiding and abetting claim appeared irrational on its face. A9-A10. In the context of secondary liability, this approach is accepted, *see, e.g.*, *Smith* v. *Ayres*, 845 F.2d 1360, 1365 (CA 5 1988) (dismissing an aiding and abetting claim under Rule 9(b) because it "alleged no facts supporting an inference of substantial or knowing assistance"), is endorsed by the treatise petitioners cite, *see* 2A J. MOORE & J. LUCAS, MOORE'S FEDERAL PRACTICE ¶ 9.03[3], at 9-47, 9-48 (2d ed. 1990) (Pet. at 7) ("Allegations of aiding and abetting must describe the fraud aided and set forth the circumstances demonstrating that the defendant knowingly rendered substantial assistance to the fraud"), and does not conflict with the cases petitioners cite. *See Seattle-First National Bank* v. *Carlstedt*, 800 F.2d 1008, 1011 n.2 (CA 10 1986) (Pet. at 6, 9) (upholding sufficiency under 9(b) of primary fraud allegations, but noting that "to the extent the counterclaim and amended counterclaim seek to impose aiding and abetting liability under the securities laws . . . based on routine participation in the loans to defendants, such claims would not satisfy Rule 9(b)"); *Christidis* v. *First Pennsylvania Mortgage Trust*, 717 F.2d 96, 98-100 (CA 3 1983) (Pet. at 6) (dismissing primary fraud claims under Rule 9(b); no mention of any aiding and abetting claims); *Cramer* v. *General Telephone & Electronics Corp.*, 582 F.2d 259, 273 n.17 (CA 3 1978) (Pet. at 6) (withholding decision as to whether complaint adequately alleged scienter as to accounting firm).

CONCLUSION

For the reasons set forth above, the petition for a writ of certiorari should be denied.

DATED: New York, New York
October 10, 1990

Respectfully submitted,

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No. 90-416

IN THE

Supreme Court of the United States

OCTOBER TERM, 1990

ROCCO DiLEO and LOUISE DiLEO,

Petitioners,

vs.

ERNST & YOUNG,

Respondent.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

REPLY TO BRIEF IN OPPOSITION

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REPLY TO BRIEF IN OPPOSITION

A.

The petition for certiorari seeks resolution by this Court of a conflict among circuits as to whether pleading scienter generally is sufficient, or whether, as was held below, one must plead facts supporting an inference that defendant acted with the requisite mental state. The issue arises in the context of a claim brought under Section 10(b) of the Securities Exchange Act. The complaint alleges that respondent, knowingly or recklessly, certified fraudulent financial statements.

Respondent's brief argues that the issue of whether the complaint adequately pleads state of mind arises in "the context of secondary liability". (Res. Br. 7) Respondent seriously misreads the decision of the Court of Appeals. The decision makes clear that the court considered pleading scienter in connection with a claim that respondent is primarily liable. The decision opens its discussion of scienter at App. 8, stating, "[m]oreover, the complaint offers no reason to infer that E&W possessed the mental state necessary for a *primary* violation." [Emphasis added.]

Careful reading makes it obvious that the decision of the Court of Appeals requires that a claim for *primary* liability under §10(b) plead facts from which "an *inference* of scienter" may be drawn. (App. 10) The petition for certiorari seeks resolution of a conflict among circuits concerning the standard for pleading scienter in connection with a claim asserting primary liability. It does not involve special pleading rules pertaining to alleging secondary liability under the securities laws as argued in respondent's brief. (Res. Br. 8-10)

B.

Respondent's brief raises the specter of unresolved questions concerning secondary liability in an attempt to make the granting of the petition for certiorari appear imprudent. At page 8, respondent's brief states:

> We note that the Court would initially have to decide the substantive issue, twice specifically reserved by the Court, of whether there is aiding and abetting liability at all under §10(b) of the Securities Exchange Act and Rule 10b-5.

Secondary liability is not an issue raised in this petition. The complaint alleges that respondent falsely certified finan-

cial statements. By that conduct respondent made untrue statements of material fact and failed to state material facts. The certifications' fraudulent assertions that Continental's financial statements accurately reflected its financial condition and the results of its operations constitute primary violations under Section 10(b). It is that respondent made fraudulent statements of which petitioners complain; the question of whether respondent had a duty to disclose is not here at issue. (Res. Br. 8)

C.

Respondent's brief characterizes the issue presented by the petition for certiorari as a problem of applying accepted legal standards to the allegations in the complaint. Respondent states:

> No question of law, much less conflict among the circuits, is presented, but only the application of established principles to these particular allegations. (Res. Br. 2)

Respondent's position is incorrect. Rule 9(b) requires pleading circumstances of fraud with particularity; the decision below demands that a complaint plead evidence.

The complaint sets forth the "circumstances" of the conduct complained of with "particularity". It alleges far more than "that Continental did not increase its reserve for bad loans quickly enough." (Res. Br. 3) It states that respondent certified two fraudulent financial statements; it identifies those financial statements; it designates the categories of assets, liabilities and income items which were misstated; it quantifies the misstatements; and it lists accounting standards which respondent violated. It does set forth the "who, what, when, where and how" of respondent's fraud. (App. 5)

What the complaint does not do, and the reason that it was dismissed by the Seventh Circuit, is plead evidence. It does not "give examples of problem loans". (App. 4) Rule 9(b) requires pleading "circumstances" of fraud with "particularity". The court below has perverted that requirement, and has made the pleading of evidentiary details a prerequisite to stating a claim for fraud.

CONCLUSION

This Court should give guidance in two critical areas never addressed by it in the more than 50 years since Rule 9(b) has regulated pleading in the federal system and about which grave conflicts exist.

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